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IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1929.

No. 250

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

OX FIBRE BRUSH COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT.

BRIEF FOR RESPONDENT.

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ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT.

BRIEF FOR RESPONDENT.

STATEMENT OF THE CASE.

Petitioner's statement of the facts relating to the question of whether the additional compensation paid to respondent's president and treasurer in the year 1920 was for services rendered during that year, or whether it was for services performed in prior years, seems inadequate. On this point the United States Board of Tax Appeals specifically found as follows:

> "From all of the evidence adduced, we are of the opinion that the additional compensation voted and

accrued in May, 1920, was intended to be as and for, and was as and for, salaries for the year 1920." 8 B. T. A. 422, 425; R. 12.

To this finding of the Board of Tax Appeals no error was assigned. In the preparation of a statement of the evidence to be used on appeal attention was not directed to the facts bearing upon the question of whether the additional compensation was for services performed in 1920, or for services performed in prior years.

This finding of the Board of Tax Appeals is supported by evidence. Respondent's president and treasurer, in addition to regular duties, rendered special services in the early part of 1920 before the extra compensation was voted. The record states:

> "In the months immediately prior to May 7, 1920, Mr. Robinson and Mr. McEwen both rendered special services to the corporation. That year was a very busy year for both Mr. Robinson and Mr. McEwen, and they had negotiations up with two big plants that wished to sell out, one of them going so far as to make an offer to the Ox Fibre Brush Company to take over the management if it would do so without its paying anything. This was the Brommel Brush & Fibre Industry, located in Cincinnati. The negotiations were dropped in the middle or latter part of April, 1920. It was necessary for Mr. McEwen and Mr. Robinson to travel considerably in connection with these negotiations. They visited the plants in Cincinnati and did other work of that sort relating to the negotiations necessitated in considering this proposition." (R. 25).

The Board of Tax Appeals made the following finding to the same effect:

> "During the early part of the year 1920 the petitioner was negotiating with two large brush-manufacturing concerns relative to purchasing those concerns. These negotiations were dropped in April, 1920, but while pending they necessitated on the part of Robinson and McEwen considerable travelling, visiting of plants and work pertaining to the possible reorganization thereof.

The plants, the purchase of which was under consideration, subsequently failed." 8 B. T. A. 422, 423; R. 9.

The year 1920 was the peak year in dividends. Dividends increased from nothing in 1908 and 1909 to cash dividends of $123,275 and a stock dividend of $300,000 in 1920, thus making a total of $423,275 for that year. (8 B. T. A. 422, 424; R. 11, 28.)

Mr. Crawford, who received his academic training in engineering at the Royal College of Science in Dublin, Ireland; who had been with the General Electric Company, Westinghouse Electric Manufacturing Company, and the Western Electric Company; who had been in charge of the Hawthorne Shops of the Western Electric Company where he had direct supervision over six or seven thousand employees (R. 22); and who knew the market value of the services of repsondent's president and treasurer, testified as to the value of the services of these officers as follows:

"When we took into consideration the services of the men in question, what they had been doing, what the company was when they took it over, what its financial condition was, what its standing was in the art, and then saw how the money we had invested was beginning to bring us in a very substantial return, and how the company had risen to the foremost rank in the business world of brush making; when we saw that we had just received a 50 per cent stock dividend on our stock, we thought that anything less than $24,000 would have been absolutely inadequate, and, besides, we had another project in view: We thought the best way to continue the prosperity that we had enjoyed was to make it worth these men's while to give us the same type of service. We also had one other matter in mind, that we could not get anything like the type and quality of service that the company was getting from these two men at the time, and if we went out into the open market to buy that we would have had to pay far more than their drawing account and the salary accounts of these two men represented." (R. 27.)

"I considered that if we had to go in the open market and hire that kind of services we would have had to

pay $30,000 to $50,000 a year. Those men at that time were not only taking care of the services of Treasurer and President, they were handling all of the large purchases of our company, and they were directing the hiring of the personnel, as you see, by the fact that they hired me. They were directing the policy of the company, and even directing the lines along which factory development should go. They were doing the work of probably five men in addition to the executive duties of President and Treasurer." (R. 27, 28.)

SUMMARY OF THE ARGUMENT.

Petitioner erroneously assumes that the additional compensation voted and paid in 1920 was for services rendered in prior years. The total compensation paid during the year 1920 was no more than a reasonable allowance for personal services rendered during that year.

Under section 234(a)(1) of the Revenue Act of 1918 a taxpayer keeping its books on the accrual basis of accounting may deduct additional compensation for services rendered in prior years in the year in which the additional compensation is incurred. *S. Naitove & Company* v. *Commissioner*, 32 F(2d) 949 (C. A. D. of C., certiorari denied October 21, 1929, 74 L. ed. 57); *United States* v. *Block & Kohner Mercantile Company*, 33 F(2d) 196 (D. C. Mo.); *Green Oil Soap Company* v. *Reinecke*, (D. C. Ill., decided December 18, 1929, not yet officially reported); *Wunderle* v. *McCaughn*, (D. C. E. D. Pa., decided June 5, 1929, not yet officially reported); G. C. M. 941 VI-1 Cumulative Bulletin 205; *Appeal of Van De Kamps Holland Dutch Bakers*, 2 B. T. A. 1247.

Section 212 of the Revenue Act of 1918 has no application to the case at bar for the reason that the income to be accurately reflected is the taxable net income, a statutory concept expressly defined in the statute, not the individual concept of net income entertained by the employees of the Bu-

reau of Internal Revenue. Section 212 refers to the method of accounting and not to the treatment accorded on the books of the taxpayer to an isolated transaction. *Stern* v. *Commissioner,* 13 B. T. A. 1192. In determining the deduction for compensation, and in arriving at the statutory net income, section 212(b) refers directly to section 234(a)(1).

The argument of counsel for petitioner necessitates reading into section 234(a)(1) four words which are not there and which were never intended to be there. They are driven to the extreme contention that the additional compensation in this case is not deductible in any year.

The requirement of section 234(a)(1) that the allowances for services must be reasonable in amount prevents any distortion of income and will go the whole way in eliminating the objections which counsel for petitioner urge against respondent's position.

ARGUMENT.

Petitioner erroneously assumes that the additional compensation voted and paid in 1920 was for services rendered in prior years.

(A) The Board of Tax Appeals found that the additional compensation voted and paid in 1920 was for services rendered in that year, and there is evidence in the record to support its finding.

Respondent's president and treasurer rendered special services in the early part of 1920 in connection with two proposed mergers or consolidations. This work, which was in addition to their regular duties, required an appraisement of the net worth of the companies to be merged or consolidated; an investigation of the earnings of such companies for years prior to the investigation; a consideration of the facts with reference to the location of the plants; the supply of labor available to the plants; the efficiency of the plants for the purposes for which they were being used; whether the particular companies would lend themselves to unity of management and control, and other related questions. An error of judgment or an improper interpretation of any of the many elements might mean disaster.

Of course, in determining the amount of the additional compensation, respondent's board of directors examined the past record of the company and of its president and treasurer. Equally important considerations in the minds of the directors were: (1) the large dividends which had been paid in 1920; (2) the fact that the market value of the services the president and treasurer were rendering was from $30,000 to $50,000 a year each; and (3) that the best way to continue

respondent's prosperity was to make it worth these men's while to give it the same type of service in the future as they had in the past.

No error was assigned to the finding of the Board of Tax Appeals that the additional compensation was as and for salaries for the year 1920. Since this court and the Circuit Court of Appeals for the Fourth Circuit may notice only plain errors where there is no error specified (Revised Rules of the Supreme Court of the United States, Rule No. 27, Subdivision 4; Rules of the United States Circuit Court of Appeals for the Fourth Circuit, Rule No. 11), it is respectfully submitted that this finding of the Board of Tax Appeals has not been preserved for review.

(B) The total compensation, including the $24,000 each paid to respondent's president and treasurer in 1920, was no more than a reasonable allowance for their personal services rendered during that year. The market value of such services as these men were rendering in 1920 was from $30,000 to $50,000 a year each. Further pertinent facts are stated by the Circuit Court of Appeals for the Fourth Circuit (32 F. (2d) 42, 43, 44; R. 33, 34), wherein the court, after reviewing the history of the services of these employees from 1906 forward, pointed out that during 1920 "in addition to their regular executive duties, the president and treasurer handled all large purchases, directed all sales, the hiring of personnel, and also directed the general policies of the company"; that "the percentage of officers' salaries to gross income for 1920 was 5.8 per cent," and that "the net income in 1920, namely, $158,753.67, after deduction of all expenses, including officers' salaries, represented a return of 21.13 per cent on invested capital of $751,038.31, as determined by the Commissioner of Internal Revenue for that year. As a result of the Bureau's disallowance of the $48,000 here in question, the taxable net income for 1920 of the company was $206,753.67 or a return of 27.53 per cent on invested capital and surplus."

The Circuit Court of Appeals, although reaching the conclusion that the extra compensation of $24,000 each voted and paid to the president and treasurer of respondent in May, 1920, was for services rendered in prior years, also found that the total compensation of $75,000 paid to these men in 1920 was but a reasonable allowance for services performed by them during that year (32 F. (2d) 42, 48; R. 40, 41):

> "Adopting, merely for the sake of illustration, the theory of the Board of Tax Appeals that the additional allowances were for services in 1920, the total salaries paid to these officers in that year were $75,000, or less than 6 per cent of the gross income. After deduction of these salaries and all other expenses, the return of stockholders exceeded 33 per cent. While, of course, each case must be determined upon its own peculiar facts, these percentages obviously do not reflect any impropriety in the allowances in question. See *United States* v. *Reitmeyer* (D. C.) 11 F. (2d) 648; *Wood & Ewer Co.* v. *Ham* (D. C.) 14 F. (2d) 995."

For cases in addition to those cited by the court where higher percentages were approved, see *Appeal of Rothholz Examining and Shrinking Co.*, 3 B. T. A. 721 (21 per cent of gross sales); *Appeal of Frank-Sievers Undertaking Co.*, 3 B. T. A. 94 (30 to 33 per cent of gross sales); *Appeal of The Record Abstract Co.*, 2 B. T. A. 628 (30 to 37 per cent of gross sales); *William S. Gray & Company* v. *United States*, Court of Claims, decided December 2, 1929, (40 to 93 per cent of net income before salaries; the court cited many cases with percentages ranging from 46 to 295 per cent, the average being 110 per cent).

This taxpayer keeping its books on the accrual basis of accounting may deduct additional compensation for services rendered in prior years in the year in which the additional compensation is incurred.

Prior to 1920 respondent's president and treasurer were paid fixed yearly salaries. Prior to 1920 they had no claim

to additional compensation. They first received the right to additional compensation, and respondent first incurred liability therefor, on May 6, 1920, when the additional compensation was voted by respondent's board of directors. The liability was not incurred nor did it accrue until that time. This additional compensation was paid during the year 1920. That this additional compensation was not only paid, but also incurred and accrued during the year 1920, counsel for petitioner admit. (Brief 7, 10.)

Counsel for petitioner are driven to the extreme contention that the additional compensation in this case is *not deductible in any year.*

As we understand their argument, it is this, that while a taxpayer keeping its books and rendering its income tax returns under the Revenue Act of 1918 upon the accrual basis of accounting may not deduct a liability until it has been incurred, become fixed and accrued, in the case of the payment of compensation for personal services there may be no deduction unless the services are rendered and the liability to pay therefor incurred in the same year in which the services are rendered. Counsel, in making this argument, rely on section 212 of the Revenue Act of 1918 to the effect that net income shall be computed according to the taxpayer's regular method of accounting if that accounting clearly reflects the income; but that if it does not, the computation is to be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect income (Brief 10, *et seq.*).

This section has no possible application to the case at bar for the reason that the "income" to be accurately reflected is the taxable net income, a statutory concept expressly defined in the statute, not the individual concept of net income entertained by the employees of the Bureau of Internal Revenue. The statutory net income is the gross income as defined by section 233 less deductions allowed by section 234.

In so far as the deduction for compensation is concerned, taxable net income is accurately reflected within the meaning of section 212 (b) if the terms and provisions of section 234 (a) (1) are satisfied, and not otherwise.

Moreover, it is plain from the language of section 212 (b) that it was intended only to authorize the Commissioner to prescribe general accounting methods, which would adequately reflect income. It was not intended to authorize the Commissioner to substitute his individual conception of the proper deductions, in place of those expressly specified in section 234 of the statute. The Board of Tax Appeals has so held. In *Stern Bros.* v. *Commissioner,* 13 B. T. A. 1192, the Board said that section 212 (b) "* * * refers to the method of accounting and not to the treatment accorded on the books to an isolated transaction." Under section 212 (b) the Commissioner may require the taxpayer to adopt a suitable and proper system of accounting, the cash system, the accrual system, possibly a hybrid system in certain cases, or any other system necessary accurately to reflect the taxpayer's statutory net income. In determining the deduction for compensation and in arriving at the statutory net income section 212 (b) refers directly back to section 234 (a) (1).

Section 234 (a) (1) provides in part as follows:

> "Sec. 234 (a). That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:
>
> (1) All ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, * * *."

Any deduction under this section of the Act cannot distort income, because to be deductible, the salary or other compensation must be an ordinary and necessary expense and must constitute in the aggregate a reasonable allowance

for personal services actually rendered. It seems clear that there can be no distortion of income where the salaries or other compensation paid are necessary expenses and reasonable for the services actually rendered. The very fact that the salaries or other compensation paid are ordinary and necessary business expenses and are reasonable for the services actually rendered necessitates their allowance in computing net income in order *to avoid a distortion by overstating the income.*

We think it will be recognized that usually and generally bonuses and additional compensation are voted and paid in the year subsequent to the year in which the services were rendered. This is due to the fact that a board of directors, in voting bonuses and additional compensation, insist upon having before them the earnings of the corporation, and from the nature of things the earnings are not definitely known until after the end of the year. To construe section 234 as contended for by petitioner would have the effect of not allowing as a deduction for any year bonuses or additional compensation incurred and paid in a year other than the year in which the services were rendered, notwithstanding the fact that the statute specifically allows the deduction of all ordinary and necessary expenses incurred or paid during the year, including a reasonable allowance for salaries or other compensation for services actually rendered. Manifestly, Congress never intended such a result. Furthermore, the result of such a construction would render the making and filing of income tax returns an interminable accounting proposition. If the taxpayer is unable to determine that upon the accrual basis of accounting he is entitled to deduct all liabilities which have been incurred in the year, whether payable at that time or not, it would seem obvious that before taking deductions he would have to seek expert counsel on each item in order to be advised whether the taking of a given deduction might or might not be construed as distorting income. In fact, counsel for petitioner recognize

this fact and are forced to say (Brief 17) that the taxpayer in this case "has placed itself in a position where no deduction can properly be allowed in any year."

We submit that such contentions of the Commissioner are contrary to practically every court decision, to a multitude of decisions of the United States Board of Tax Appeals, to the rulings of the Bureau of Internal Revenue and its Commissioner, which not only stand unrevoked but unmodified, and under which the Bureau of Internal Revenue is acting and on the basis of which it is disposing of cases at the present time.

Section 234 of the Revenue Act of 1918 does *not* read "including a reasonable allowance for salaries or other compensation for personal services actually rendered during the taxable year." It simply reads "personal services actually rendered." The statute imposes no restriction as to the year in which the services must be performed. The test of a corporation's right to deduct such payments is that the amounts are reasonable for services actually rendered. In answering a similar argument made to the Circuit Court of Appeals the court said (32 F.(2d) 42, 45, 46; R. 36, 37):

> "The statute imposes two requirements: First, that the proposed allowance shall be a *necessary* expense, and second, that it shall be reasonable.
>
> • • •
>
> "The statute does not limit its application to services rendered *within the taxable year.*"

There are other court decisions in accord. *S. Naitove & Company* v. *Commissioner*, 32 F. (2d) 949, (C. A. D. of C. certiorari denied October 21, 1929, 74 L. Ed. 57), goes further than necessary to sustain the case at bar. The resolution of the board of directors of S. Naitove & Company voting the additional compensation was passed on February 10, 1919. It was resolved that additional compensation should be paid for the year 1919 to five named individuals, three of

them each to receive ten per cent of the net profits, and two of them each to receive five per cent of the net profits. But it was further provided in the resolution that any and all sums to which these six persons might become entitled under the terms of the resolution should remain in the business at the risk of the business for a period of five years. The court held that the portion of the profits accruing to the six employees under the terms of the resolution was not deductible from the corporation's income in the year in which the services were rendered but was deductible at the expiration of the five-year period. The court said, quoting *Edwards* v. *Keith*, 231 Fed. 110, (C. C. A. 2nd) p. 952:

> "'The statute does not provide that the "personal services," compensation for which is to be considered income, must be rendered in the same year in which the compensation is received. • • •'"

The court added:

> "The decision of the court in the above case is conclusive, we think, of the effect that in a unilateral or conditional contract, as the one here involved, the liability incurred is not to be deducted as expense until it has become fixed and determined, and it is then deductible as of the year when that event occurs—in the instant case, at the expiration of the five-year period."

One of the cases cited and relied upon by the Court of Appeals of the District of Columbia, *United States* v. *Block & Kohner Mercantile Company*, 33 F.(2d) 196 (D. C. Mo.), is similar. In that case the taxpayer corporation, on February 1, 1919, made a contract with an employee in which the employee agreed to work for the company at a salary of $4,800 per annum, payable monthly. In addition, the employee was to receive one-third of the net profits of the taxpayer company during the life of the contract. If net losses resulted from the business, one-third of such losses were to be deducted. One-third of the profits for the year 1919 amounted to $5,193.27, and this amount was credited on the

books of the taxpayer to the employee; but losses for 1920 and 1921 exceeded the profits for 1919, leaving nothing due the employee at the termination of the contract. The taxpayer company sought to deduct from its income for 1919 as expense the amount credited that year to the employee. The court held that this could not be done; that notwithstanding the fact that the services covered by the 1919 credit were rendered during that year, the liability to pay for these services had not been incurred during 1919, and, hence, they were not deductible.

To like effect is *Green Oil Soap Company* v. *Reinecke* (D. C. Ill.), decided December 18, 1929, not yet officially reported, (Ill. C. C. H. Federal Tax Service, 1929, pp. 9904, 9905). The court after quoting at length from the opinion of the Circuit Court of Appeals in the case at hand and from *Edwards* v. *Keith*, 231 Fed. 110 (C. C. A. 2d), continued:

> "The court is of opinion that under the Revenue Act of 1918, as construed by the cases above quoted from and from others cited on the argument, there is no justification for the contention that the deduction for compensation for personal services actually rendered is limited to services rendered within the taxable year."

The court distinguished *W. S. Bogle & Co.* v. *Commissioner*, 26 F.(2d) 771, relied upon by petitioner.

See, also, *Wunderle* v. *McCaughn*, (D. C. E. D. Pa.) decided June 5, 1929, not yet officially reported, (1929, III Commerce Clearing House Federal Tax Service, pp. 8652-8654) where the court said:

> "The defendant (the Collector of Internal Revenue) raises the question that, if it is a bonus, it is not allowable for the year in which it was charged off, but must be prorated over the years during which the services were rendered. This would be true if it had been payable as a result of some legal obligation or promise incurred or made in connection with the employment, but it is not true where, as in this case, there is no such obligation existing."

The Board of Tax Appeals has ruled repeatedly that compensation to be deductible need not be incurred in the year in which the services are rendered. *Appeal of Jamestown Worsted Mills,* 1 B. T. A. 659, Commissioner has acquiesced (IV-1 Cumulative Bulletin 1, 2); *Appeal of Flint River Brick Co.,* 2 B. T. A. 31, Commissioner has acquiesced (IV-2 Cumulative Bulletin 1, 2); *Appeal of Lihue Plantation Co., Ltd.,* 2 B. T. A. 740; *Appeal of Van De Kamps Holland Dutch Bakers,* 2 B. T. A. 1247; *Appeal of Arter Paint & Glass Co.,* 2 B. T. A. 1256; and *Appeal of Washington Cadillac Co.,* 3 B. T. A. 844. The Commissioner acquiesced in all of these decisions. (V-1 Cumulative Bulletin, 1, 4, 6.)

In the *Holland Dutch Bakers* case the Board said, p. 1251:

> "Additional compensation or 'bonus' payments have become, especially since this country entered the World War, a recognized form of salary payment, used for the purpose of retaining the interest of the employee in the business without at the same time incurring any obligation in advance of the payment. Services are performed for salaries which would otherwise be inadequate, the person rendering them expecting to receive such a bonus but the employer being under no obligation to pay it. Such payments also have in them an element looking to future services, the recipient anticipating a further similar payment if the business justifies it.
>
> • • •
>
> "It remains to determine in what year the deduction is to be allowed. Was the obligation incurred in the year when the services were rendered or was it incurred when the additional compensation was voted? Until it was voted there was nothing more than a moral obligation; there was no legal obligation which could be enforced. We must accordingly hold that the $7,000 of additional compensation, voted in 1920 for services rendered in 1919, was an obligation incurred in 1920 and is deductible in that year and not in 1919."

After the Commissioner had acquiesced in several decisions of the Board of Tax Appeals holding that compensation for services performed in prior years was deductible in the sub-

sequent year in which it was incurred, he, through A. W. Gregg, then General Counsel, Bureau of Internal Revenue, issued a formal ruling to the same effect, and revoked a prior inconsistent ruling. G. C. M. 941, VI-1 Cumulative Bulletin 205 (1927). The General Counsel said, pp. 206-208:

> "The material facts in the case under consideration are the authorization and payment in 1918 of compensation for 1917 and additional compensation for prior years and the contention of the taxpayer that the amount is deductible in the return for 1918. * * *"

Reviewing a number of decisions of the Board of Tax Appeals, acquiesced in by the Commissioner, the General Counsel concluded:

> "Summarizing the foregoing conclusions and specifically answering the three inquiries submitted, it is the opinion of this office that—
>
> "(1) In view of the decisions of the Board of Tax Appeals cited by the taxpayer and of the other decisions of the Board involving the same question in which the Commissioner has acquiesced, the additional compensation voted and paid by the taxpayer in its fiscal year 1918 to its President for services performed in 1917 and in prior years is deductible as an expense of the fiscal year 1918;
>
> "(2) The ruling in Advisory Tax Board Memorandum 86 that additional compensation voted and paid subsequent to the close of the year in which the services were rendered is not deductible in any year has been modified by the acquiescence of the Commissioner in decisions of the Board of Tax Appeals which hold contrary thereto. * * *"

Accord: *Commercial Electrical Supply Co.* v. *Commissioner,* 8 B. T. A. 986; *Jerecki Mfg. Co.* v. *Commissioner,* 12 B. T. A. 1165; *Roubaix Mills, Inc.* v. *Commissioner,* 7 B. T. A. 878.

Counsel for petitioner admit in their brief (19) that G. C. M. 941 is in accordance with "the view here asserted by the taxpayer." Not only that, but it stands unrevoked and un-

modified at the present time. It is the ruling under which the Bureau of Internal Revenue is now acting and on the basis of which it is disposing of other cases.

Moreover, the official regulations promulgated by the Treasury Department under Section 234(a)(1) have adopted the same interpretation of that section. Article 561 of Regulations 45, under the Revenue Act of 1918, refers to Article 105, which reads, in part, as follows:

> "Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. *The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.*" (Italics ours.)

This provision has remained unchanged through all the regulations. See Article 105 of Regulations 62 under the Revenue Act of 1921, Articles 106 of Regulations 65 under the Revenue Act of 1924 and Regulations 69 under the Revenue Act of 1926, and Article 126 of Regulations 74 under the Revenue Act of 1928.

Article 107 of Regulations 45 provides:

> "Gifts or bonuses to employees will constitute allowable deductions from gross income when such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered."

Aside from certain slight changes in wording, this article has also remained the same through all the regulations. See Article 108 of Regulations 62, Articles 108 of Regulations 65 and Regulations 69, and Article 128 of Regulations 74.

It is a matter of common knowledge that bonuses often are voted and paid in a subsequent year for services performed in a prior year. The regulations in no way restrict the deduction to bonuses voted and paid during the taxable year for services performed during that year.

The converse of the case at bar is compensation paid to the taxpayer for services rendered by him in prior years. In such circumstances the courts hold the compensation taxable to the employee in its entirety in the year received. *Jackson* v. *Smietanka*, 272 Fed. 970 (C. C. A. 7th) affirming 267 Fed. 932 (D. C. N. D. Ill.); *Edwards* v. *Keith*, 231 Fed. 110 (C. C. A. 2nd). It need not be added that the government has collected an income tax for 1920 on the total compensation of these two officers from the individuals.

There are many analogous decisions which support respondent's construction of sections 212 and 234(a)(1). See *Highland Milk Condensing Co.* v. *Phillips*, 34 F. (2d) 777 (C. C. A. 3rd); *Vang* v. *Lewellyn*, 35 F. (2d) 283 (C. C. A. 3rd); G. C. M. 1342, VI—1 Cumulative Bulletin 177; *Western States Envelope Co.* v. *Commissioner*, 10 B. T. A. 856.

The case of *United States* v. *Anderson*, 269 U. S. 422, much relied upon by counsel for petitioner, is easily distinguishable. There it was held that a tax imposed by the Munitions Tax Act of 1916 was a proper accrual for the year 1916 and deductible in that year, though the tax was not required to be paid until 1917; but as was pointed out by the Circuit Court of Appeals for the Fourth Circuit, the events which fixed the amount of the tax and determined the precise amount of the liability all occurred in 1916. From the events that occurred in 1916 the taxpayer in that case knew precisely how much he would be required to pay because of those events. In our case there was nothing of the kind until respondent's board of directors met on May 6, 1920. The matter was put as follows by the Circuit Court of Appeals for the Fourth Circuit:

> "Under the accrual system, an expense accrues when all events have occurred from which liability is determined and has become fixed, even though payment be not yet due. That is to say, the basic idea is that the books shall immediately reflect obligations and expenses definitely incurred, and income definitely earned, with-

out regard to whether payment has been made or is due. This was the theory upon which the case of *United States* v. *Anderson, supra,* was decided. Thus, when in the present case the Government argues that, if a resolution, authorizing additional compensation, be passed subsequent to the year in which the services to be compensated were rendered, the corporation must allocate the payment to the proper years and file amended returns for those years, claiming the deduction in the amended return, it misconceives the basic idea of the accrual plan." (32 F. (2d) 42, 47; R. 39.)

Concerning the case of *W. S. Bogle* v. *Commissioner,* 26 F. (2d) 771 (C. C. A. 7th) affirming 5 B. T. A. 541, also much relied upon by counsel for petitioner, it may be observed that the total compensation was not reasonable for the services performed in the year in which it was paid. In that case the Board of Tax Appeals said, p. 552:

"Since the petitioner claims the deduction in this case for the year in which the additional salary was voted and paid, it must come within the ordinary provisions governing such deductions if it is to be allowed. The petitioner has not shown that the services actually rendered during the year 1917 were such as to make the payment of the full amount, including the amount paid on account of services rendered for prior years, reasonable compensation for the year in which the salary was paid."

To the foregoing statement of the Board of Tax Appeals may be added the statement of the Circuit Court of Appeals for the Seventh Circuit to the effect that "where a salary has been fixed and fully paid for one year, it cannot be increased in some later year (when profits are larger) and the increase deducted from the net profits of the prosperous year," thus further implying, as was pointed out by the Circuit Court of Appeals in the case at hand in discussing the *Bogle case,* "that the additional compensation rendered the total salary unreasonable and excessive." 32 F. (2d) 42, 46; R. 38. The same comment on the *Bogle case* is to be found in *Green Oil Soap Co.* v. *Reinecke, supra.*

With reference to the last case especially relied upon by counsel for petitioner, namely, *Model Dairy, Inc.* v. *Commissioner*, C. C. A. 8th, December 10, 1929, affirming 13 B. T. A. 545, a similar distinction must be made. There the Board ended its opinion with the following sentence, page 550:

> "Upon the record here we are unable to determine that total deductions claimed on account of salaries for the years 1922 and 1923 were reasonable compensation for the services rendered."

Counsel for petitioner argue that the delay until 1920 was due to the failure of respondent's board of directors to vote the additional compensation in the year in which it was earned, and say that it results in arbitrary shifting of deductions. The Circuit Court of Appeals for the Fourth Circuit answered this argument as follows, pp. 46, 47:

> "That the practice here sanctioned may be subject to abuse is not sufficient to condemn it. Whether there is actual abuse becomes a question of fact in each case. A corporation with a large surplus in a given year may attempt to dispose of that surplus in the guise of salaries and thereby evade its full tax burden, but there is no evidence that such occurred in the present case; nor is there any bad faith to be deduced from the fact that these officers, together with their families, owned approximately 36 per cent. of the company's stock. The additional compensation was voted to them not because they were stockholders, but because they performed services as employees of the corporation which its board of directors believed to have been peculiarly valuable. If rigid rules of accounting are allowed to supplant that reasonable amount of flexibility which must, from the very nature of things, go hand in hand with the vicissitudes of business, loyalty and ambition on the part of employees will become deadened, and those persons whose services are essential to the success of a given enterprise will be unavailable at the very time when they are most needed. For a corporation to defer payment of full compensation to its employees in times of stress, is no different in principle from the deferring of any of its other obligations. Both must be met in due course. Tax laws should aim to encourage, not to oppose, this result, and should be so construed, unless clearly expressive of a contrary intent."

It is important to observe that the requirement that the total compensation must be reasonable in amount for the services rendered will go the whole way in eliminating the objections which counsel for petitioner urge against respondent's position.

With reference to the shifting of deductions counsel for petitioner also mention that during the period of the war the need for revenue was great, and that there were excess and war profits taxes. In this connection we may note that from a tax point of view it would have been to respondent's detriment to postpone until 1920 paying for services rendered during the war years. Admittedly, income and profits tax rates were higher during the war years (1917 and 1918) than they were in 1920; the rates for 1919 and 1920 were the same.

CONCLUSION.

It is, therefore, respectfully submitted that the decision of the Circuit Court of Appeals for the Fourth Circuit should be affirmed.

Respectfully submitted,

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